

STEPHAN CO
Form 10-K/A
December 08, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K/A
Amendment No. 1

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Fiscal Year Ended December 31, 2008

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File Number 1-4436

THE STEPHAN CO.
(Exact name of registrant as specified in its charter)

Florida
(State or other jurisdiction of incorporation or organization)

59-0676812
(IRS Employer Identification No.)

1850 West McNab Road, Fort Lauderdale, Florida 33309
(Address of principal executive offices)(Zip Code)

Registrant's telephone number, including area code: (954) 971-0600

Securities Registered Pursuant to Section 12(b) of the Act:

| Title of each class | Name of each exchange on which registered |
|-----------------------------------|---|
| Common stock, \$0.01 par value | NYSE - AMEX |

Securities registered pursuant to section 12(g) of the Act: None.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
YES NO

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.
YES NO

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Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES
x NO

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (Section 229.405 of this chapter) is not contained herein, and will not be contained, to the best of the Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell Company (as defined in Rule 12b-2 of the Exchange Act). YES NO

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter: \$11.5 million.

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date:

4,252,675 shares of common stock, \$0.01 par value, as of March 23, 2009

List hereunder the following documents if incorporated by reference and the Part of the Form 10-K into which the document is incorporated: (1) any annual report to security holders; (2) any proxy or information statement; and (3) any prospectus filed pursuant to Rule 424(b) or (c) under the Securities Act of 1933: None.

EXPLANATORY NOTE

We are filing this amendment to our Annual Report on Form 10-K for the year ended December 31, 2008 to reflect changes made in response to comments received by us from the Staff of the Securities and Exchange Commission in connection with the Staff's review of our Annual Report on Form 10-K for the year ended December 31, 2008. Pursuant to their comments we have amended Item 7 (Management's Discussion and Analysis of Financial Condition and Results of Operations) to expand our disclosure about a non-GAAP measure: EBITDA and to expand our disclosure (under Critical Accounting Policies and Estimates) to include a discussion of our methodology, results and assumptions relating to our testing of intangible assets for potential impairment. Additionally, we have expanded Item 9A (Controls and Procedures) to discuss our disclosure controls. No other changes have been made to the report as originally filed on April 1, 2009. Finally, we have included currently-dated management certifications from our Chief Executive Officer and Chief Financial Officer required by Sections 302 and 909 of the Sarbanes-Oxley Act of 2002, and they are attached to this Form 10-K/A as Exhibits 31.1, 31.2, 32.1 and 32.2.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Liquidity and Capital Resources

We had cash and cash equivalents of approximately \$8.0 million at December 31, 2008. We have minor indebtedness, principally from the acquisition of Bowman, of less than \$0.5 million. Our cash is maintained, as of March 2009, primarily in FDIC-insured bank accounts.

Our Company generated positive cash flows from operating activities primarily due to the generation of EBITDA of \$0.9 million during 2008. Our largest uses of cash were: 1) \$1.1 for debt repayment (this amount retired in full our outstanding bank loan), 2) a temporary increase in inventory of \$0.7 million, 3) \$0.5 million for the acquisition of Bowman, 4) dividends of \$0.4 million, and 5) the repurchase of our common stock, which has recently traded at historically low levels, totaling \$0.3 million. Capital expenditures were not significant.

EBITDA is a frequently-used, non-GAAP term that means Earnings Before Interest, Taxes, Depreciation and Amortization.

EBITDA is reconciled to NET CASH FLOWS PROVIDED BY OPERATING ACTIVITIES per the Company's 2008 Consolidated Statements of Cash Flows as follows:

| (in thousands) | 2008 |
|---|-----------|
| EBITDA | \$ 941(1) |
| Stock option compensation | 97 |
| Current income taxes | (26) |
| Changes in operating assets & liabilities, net of Bowman acquisition: | |
| Decrease in accounts receivable | 494 |
| (Increase) decrease in current inventories | (715) |
| Decrease in prepaid expenses and other current assets | 66 |
| (Increase) in other assets, including non-current inventories | (260) |
| (Decrease) in accounts payable and accrued expenses | (543) |
| Interest expense | (7) |
| Interest income | 211 |
| NET CASH FLOWS PROVIDED BY OPERATING ACTIVITIES | \$ 258 |

(1) \$900,000 was reported for 2008; the difference was rounding of \$41,000.

EBITDA is reconciled to net income for the last three years as follows:

| (in thousands) | 2008 | 2007 | 2006 |
|-----------------------------|--------|----------|------------|
| Net income | \$ 698 | \$ 968 | \$ (3,602) |
| Provision for income taxes | 303 | 629 | (2,129) |
| Interest expense | 7 | 24 | 39 |
| Interest income | (211) | (381) | (233) |
| Depreciation & Amortization | 144 | 182 | 209 |
| Rounding | (41) | (22) | 10 |
| Impairment loss | 0 | 0 | 6,706(2) |
| EBITDA | \$ 900 | \$ 1,400 | \$ 1,000 |

(2) 2006 EBITDA excluded intangibles impairment charges of \$6.7 million.

Management has included the EBITDA metric in its Form 10-K because of its wide and recognized existing use. EBITDA is a useful corporate valuation metric. Further, its focus is on operating, not on financial, cash flows such as interest expense and interest income. It factors out short-term changes in working capital that could vary substantially from period-to-period, thus giving the investor a more stable metric by which to judge cash flow changes over time.

The limitations of EBITDA include its exclusion of working capital changes that affect cash flow during the period. Further, it excludes interest expense, interest income, income taxes, depreciation and amortization from earnings (net income or loss). It also excludes capital expenditures which, in the Company's case, are usually immaterial.

In 2008 we sold, at par, our auction rate securities of \$3.9 million held at the end of 2007. We have adequate liquidity and do not foresee the need for additional capital for day-to-day operations in the next year. Our cash flow was helped in both 2008 and 2007 by the utilization of net operating loss carryforwards of \$0.3 million and \$0.6 million, respectively. At December 31, 2008, we had approximately \$3.2 million of net operating loss carryforwards available to offset future taxable income.

We have no off-balance sheet financing arrangements, and the Company focuses on maintaining its good credit worthiness. Further, we continue to seek acquisitions of quality companies that fit our business model.

Acquisition of Bowman Beauty and Barber Supply, Inc.

On August 14, 2008, we acquired all of the outstanding common stock of Bowman Beauty and Barber Supply, Inc. (a North Carolina corporation). Subsequently, we merged this company into our Company's wholly owned subsidiary: Bowman Beauty & Barber Supply, Inc. (a Florida corporation). Revenue from Bowman of \$1.0 million is included in the Company's 2008 results. Operating profit for Bowman was approximately \$40,000.

2008 v. 2007

Results of Operations

Our Company sells thousands of different items to various distributors, beauty schools and individuals utilizing direct salespersons, catalogs and internet advertising. We also sell our branded products through the distribution networks of our subsidiaries. In the distributor segment, we generally buy and resell several thousand beauty and barber items. In

the brands segment, we produce and sell more than one thousand items.

Revenue in our larger segment, Distributors, which constitutes about 74% of our consolidated revenue, increased by almost 2.0% in calendar 2008 compared to the prior year. This increase was due principally to the additional revenue from the acquisition in mid-August of Bowman. Without the Bowman acquisition, the segment's revenue declined about 6.7%. The gross profit percentage margin in this segment was up slightly from that in 2007.

Our other segment, Brands, which has had higher gross margins than our distributors segment, posted results more in line with expectations as its customers focused on value-priced products with which our branded products compete and have been more severely affected by the difficult state of the nation's economy. This smaller segment's revenue decreased by 30.6% compared to 2007. However, the gross margin percentage increased over 17% in this segment due to a January 1 price increase and lower manufacturing costs. These improvements mitigated the effect of the volume shortfall on the segment's gross margin dollars. However, from a consolidated viewpoint, the operating income shortfall occurred primarily in this segment.

On a consolidated basis, the productivity gains in the brands segment, coupled with an increase in the percentage of the total business represented by the distributors segment, resulted in a comparable consolidated gross margin percentage from year-to-year.

Our focus in 2008 was to control those elements of the business that we could control: we focused on more economical sources of supply; we competitively bid significant-cost items where possible; we implemented an overall cost-reduction system with specific goals, responsibilities and accountability.

Our selling, general and administrative expenses (“SG&A”), before Bowman’s SG&A, were \$0.6 million, or 7.3%, less than those in the prior year. This savings (principally due to decreased payroll and bad debt costs) mitigated the gross profit softness in the smaller brands segment. Bowman’s SG&A in 2008 was approximately \$0.3 million. Our SG&A expenses included certain estimated manufacturing-related costs of \$0.8 million and \$0.9 million in 2008 and 2007, respectively.

There were no intangibles impairment charges in 2008; we tested our intangible assets as of the end of 2008 in accordance with SFAS No. 142 and determined that goodwill/trademarks had not been impaired. We computed our TCV (total corporate value) by reporting unit using discounted cash flow analysis and other methods.

The Company’s effective income tax rate was 30.3% in 2008 compared to 39.4% in 2007 due to an adjustment of the valuation allowance resulting from the implementation of FIN 48. This adjustment related to accelerated deductions for tax purposes that may or may not be sustained upon audit. If they were disallowed, the effect would be to accelerate the utilization of the Company’s NOLs.

The consolidated result was a decline in operating profit from \$1.2 million in 2007 to \$0.8 million in 2008. Lower short-term investment rates caused by broad economic changes principally accounted for the decline in our interest income. The overall result was a reduction in net income to \$0.7 million and basic income per share of \$0.16 in 2008 compared to net income of \$1.0 million and \$0.22 per share in 2007. In the fourth quarter of 2008, as part of our normal annual review process, we increased overhead allocations to inventories by \$0.4 million to reflect cost of goods sold appropriately.

Despite a difficult operating environment, The Stephan Co. has cash of about \$8.0 million and little debt. We are pleased with our position in this tough economy as we are cushioned from adversity by significant cash balances and a small amount of debt. We have paid dividends since 1995 and did so again in 2008 and in the first quarter of 2009.

However, we anticipate that the world-wide recession will affect our business adversely in 2009. Revenue is likely to decline from 2008 levels and profitability could decline. Nonetheless, we continue to look aggressively for acquisitions, opportunities and new venues to enhance corporate value for our shareholders.

Effective about June 1, 2009, the CEO plans to unilaterally reduce his current salary by 30%, subject to the terms and conditions as outlined in NOTE 12. RELATED PARTIES.

2007 v. 2006

Results of Operations

EBITDA (earnings before interest, taxes, depreciation and amortization) was \$1.4 million in 2007 compared to \$1.0 million in 2006 (exclusive of impairment charges in 2006 that were not incurred in 2007). Our cash and short-term investments continued to grow; cash and cash equivalents and short-term investments amount were almost \$9.0 million, an increase of \$1.9 million from the end of 2006. Short-term investments include auction rate securities

currently impacted by nationwide illiquidity due to effects of the sub-prime lending crisis in the U.S.

Our Company returned to profitability in 2007, posting net income of \$968,000, or \$0.22 per share. In 2006, intangibles impairment non-cash charges of \$6.7 million contributed to a loss of \$3.6 million, or (\$0.82) per share. There were no impairment charges in 2007.

Our gross profit margin improved to 47% in 2007 compared to 44% in 2006; most of the improvement was in the brands segment. This improvement was due, in part, to 1) a more profitable sales mix in 2007 compared to that in 2006 and 2) better utilization of inventory to reduce purchases. Cost increases, particularly in oil-based products and freight increases, depressed the margin improvement. We have experienced cost increases from many vendors. Freight costs have increased as vendors have added various surcharges to their pricing structure. As of January 1, 2008, we instituted price increases to attempt to pass-through to our customers the cost increases that we have been subject to from our vendors.

Selling general and administrative (“SG&A”) expenses declined by \$6.0 million in 2007 compared to those in 2006, primarily due to the inclusion in 2006 of \$5.3 million for intangibles impairment (an additional \$1.4 million was classified as an impairment of goodwill, bringing the total non-cash charge to \$6.7 million). In 2007 and 2006 SG&A expenses included in each year approximately \$900,000 of manufacturing-related costs.

Our Company sells thousands of different items to various distributors, beauty schools and individuals. In the distributor segment, we generally buy and resell several thousand beauty and barber items. In the brands segment, we produce and sell more than one thousand items.

Revenue was soft in both of our segments (brands and distributors) as general economic conditions, lower beauty school enrollments and distributor consolidation were factors in our overall 9.4% revenue decline from that in 2006. Revenue in our brands segment, which accounted for 33.0% of consolidated revenue in 2007, was 8.8% down from that in 2006. Within our brands segment, we did see growth compared to 2006 in our Frances Denney cosmetics line and in the ethnic markets. Revenue in our distributors segment, which accounted for 67.0% of consolidated revenue in 2007, was 9.7% lower than that in 2006.

The following table sets forth certain information regarding future contractual obligations of the Company as of December 31, 2008:

| Contractual Obligations (in thousands) | Total | 1 Year | 2-3 Years | 4-5 Years | More than 5 Years |
|--|----------|----------|-----------|-----------|----------------------|
| Operating leases | \$ 2,548 | \$ 414 | \$ 827 | \$ 827 | \$ 480 |
| Employment Contracts | 3,588 | 1,070 | 2,450 | 68 | - |
| Long-term debt | 462 | 136 | 261 | 65 | - |
| Total | \$ 6,598 | \$ 1,620 | \$ 3,538 | \$ 960 | \$ 480 |

Recent Accounting Pronouncements and Developments

In Note 2 to our consolidated financial statements, we discuss new accounting policies adopted by the Company during 2008 and the expected financial impact of accounting policies recently issued or proposed but not yet required to be adopted.

Critical Accounting Policies and Estimates

In Note 1 to our consolidated financial statements, we discuss critical accounting policies and estimates used by the Company in 2008.

Goodwill, Trademarks and Other Intangible Assets

We tested the recorded goodwill, trademarks and other intangibles of both reporting units (segments) for impairment at December 31, 2008 using several methods: discounted cash flow, break-up value and comparable transactions.

In all cases, the computed fair value of the intangible assets per our testing exceeded the recorded intangible asset amounts in each reporting unit. We, therefore, concluded that no impairment of intangible assets had occurred. In the case of the Distributors reporting unit the range of the excess of computed over recorded intangible assets was between 23% and 806%, depending upon the method employed. For the Brands reporting unit the range of the excess of computed over recorded intangible assets was between 91% and 298%, depending upon the method employed.

At December 31, 2008, the recorded amounts of goodwill, trademarks and other intangible assets were \$3.6 million and \$3.1 million for the Distributors and Brands reporting units, respectively.

Principal assumptions used in the discounted cash flow method testing at the end of 2008 included: 0% growth in cash flows and 15.0% cost of capital; cash flows were computed before allocation of corporate overhead. Because the Company's business units are relatively small and may be sold separately, corporate overhead (consisting primarily of

officer and staff salaries, benefits, accounting, legal, insurance and other costs) would most likely be eliminated or reduced substantially since a potential buyer or buyers of the Company, as a whole or piecemeal, who would likely already have established overhead bases that would be capable of absorbing the additional volume generated by the products currently sold by the Company. For 2008, the corporate overhead allocated based upon reporting unit revenues was \$0.7 million for the Brands and \$2.1 million for the Distributors. For 2007, the corporate overhead allocated based upon reporting unit revenues was \$1.0 million for the Brands and \$2.0 million for the Distributors. These amounts were subtracted in arriving at operating income (loss) for the reporting units. See NOTE 11.

SEGMENT INFORMATION.

Revenue multiples from other transactions were used to test recorded goodwill based upon available comparable transactions; management estimates were used to test goodwill based upon the estimated break-up value of the reporting units.

The year-end market value of the Company's common stock (\$1.96 per share) was considered as a potential indicator of overall corporate value. With 4.3 million shares outstanding, the market value of the entire Company (approximately \$8.4 million) would be just slightly more than the Company's cash and cash equivalents at December 31, 2008. This valuation would imply that the other assets and businesses of the Company had little or no value. Consequently, we did not use the Company's year-end stock price as a valid metric in our valuation analysis.

The discounted cash flow testing assumed that the 2008 cash flow level would continue indefinitely and that this cash flow stream would be discounted to its present value using a 15.0% cost of capital. The cost of capital assumed the continuity of current interest rates, a capital structure of 70% equity and 30% debt, and included premiums for company size and specific risk aggregating 10.3%. The Capital Asset Pricing Model and the Build-Up Method results were averaged to arrive at a cost of capital of 15.0%.

Our methodologies are based upon various assumptions that are subject to uncertainties including: our assumption that cash flows in 2008 will continue indefinitely, that interest rates will not increase materially and that the Company will be sold to a buyer with an established corporate overhead and, possibly, if the buyer were an industry participant, an established production overhead base. Based upon current worldwide economic uncertainties, we are unable to predict the effect of such economic issues will have on our assumptions.

If our assumptions do not prove correct or economic conditions affecting future operations change, our goodwill could become impaired and result in a material adverse effect on our results of operations and financial position.

Item 9A: Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures designed to provide reasonable assurance that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934 is recorded, processed, summarized, and reported within the time periods specified by the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our CEO and CFO, as appropriate, to allow for timely decisions regarding required disclosure. We recognize that any controls and procedures, no matter how well designed and operated, can only provide reasonable assurance of achieving desired control objectives. Judgment is required when designing and evaluating the cost-benefit relationship of potential controls and procedures.

As of the end of the period covered by this report, with the supervision and participation of management, including our CEO and CFO, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures. Based on this evaluation, our CEO and CFO have concluded that, as of the end of such period, our disclosure controls and procedures were effective at the reasonable assurance level.

Evaluation of Internal Control over Financial Reporting

We are responsible for establishing and maintaining adequate internal control over financial reporting for the Company. During 2008 we reviewed procedures at all of our subsidiaries and evaluated the control structure of the Company as a whole. However, because of organization changes recently made in our company, including the acquisition of Bowman in 2008 that we have not had a chance to fully document, and in an abundance of caution, we believe it prudent to report that our Company did not have effective internal control over financial reporting ("ICFR") at December 31, 2008. In 2009, we will again review our controls and determine the effectiveness of our ICFR, and our auditors will attest to our ICFR determination.

This annual report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the Company to provide only management's report in this annual report.

(b) Change in Internal Control over Financial Reporting

No change in the Company's internal control over financial reporting occurred during the Company's fourth fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

SIGNATURES

Pursuant to the requirements of Section 13 of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto, duly authorized.

THE STEPHAN CO.

By: /s/ Frank F. Ferola
Frank F. Ferola
President and Chairman of
the Board
December 7, 2009

By: /s/ Robert C. Spindler
Robert C. Spindler
Principal Financial Officer
Principal Accounting
Officer
December 7, 2009
